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The profitability of winning

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Recommended Citation

Armstrong, J. S., & Collopy, F. (1994). The profitability of winning. Retrieved from http://repository.upenn.edu/marketing_papers/32

Postprint version. Published in *Chief Executive*, Number 95, June 1994, pages 61-63. The author has asserted his/her right to include this material in ScholarlyCommons@Penn.

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The profitability of winning

Abstract

Introduction: Sports and war metaphors abound in business today. For example, one management book, *Thunder in the Sky*, by Thomas Cleary, opens with a Chinese saying that translates: "The marketplace is a battlefield. The Asian people view success in the business world as tantamount to victory in battle." The book advises American executives to do the same. However, such metaphors are misleading. The objective in both sports and war is to beat the competitor. Business, on the other hand, aims to create wealth.

Ignoring this reality, many people believe the metaphors and choose competitor-oriented strategies that pursue market share rather than profits, according to research at Wharton, Weatherhead, and other institutions. In one study, one-third of 105 managers said their firms had competitor-oriented objectives. Another revealed that managers opted to sacrifice profits to beat the competition on price. A third showed that firms stating pricing goals in competitive terms had lower returns-on-investment over a 45-year span.

Our conclusion: Firms should focus on profits, not competition. Our premise is neither mysterious nor modern. It originates in classical micro-economics. Competitive objectives are especially harmful, because they likely will provoke unfavorable reactions from business rivals, which may, in turn, lead to price wars.

Comments

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The Profitability of Winning

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Sports and war metaphors abound in business today. For example, one management book, *Thunder in the Sky*, by Thomas Cleary, opens with a Chinese saying that translates: "The marketplace is a battlefield. The Asian people view success in the business world as tantamount to victory in battle." The book advises American executives to do the same. However, such metaphors are misleading. The objective in both sports and war is to beat the competitor. Business, on the other hand, aims to create wealth.

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Company Objectives

Extensive research shows that objectives have a strong bearing on group performance, a conclusion embraced by almost all management scientists. Professors Ed Locke of the University of Maryland and Gary Latham of the University of Toronto documented the research in their 1990 book, *A Theory of Goal Setting and Task Performance*. Of particular importance are objectives that are clearly stated, consistent, and formally measured. This is easy to do when using your company's own profits as an objective. In recent years, however, information technology has improved so that we now can measure the performance of competitors as well. Today, scanner data enable a company to observe a competitor's performance at the product or store level.

That leaves companies with a choice: Focus on our own performance (by setting targets for profits or ROI) or use competitor-oriented objectives such as market share. Which approach is likely to be best for the firm in the long-run? Those who advocate the latter approach say organizations looking only at their own profits tend to be short-sighted. In contrast, they observe that competitor-oriented objectives improve the firm's position over the years and thus enhance long-term performance. Most marketing experts we surveyed favor competitor-oriented objectives.

Companies themselves differ on the subject. In 1981, General Electric changed its goal from maximizing profits to maximizing market share. Merck made a similar change in 1994. In contrast, General Motors switched its objective from market share to profits in 1992. In the same year, Sony's chairman made a case for focusing on profits rather than market share.

Linking Goals to Performance

When asked to provide evidence about the effects of competitive objectives on performance, managers and academicians could only offer unsubstantiated opinions. We asked those who believe in the value of competitive

objectives what type of evidence would change their minds. Many said no evidence could do so. However, others left the door open and described the evidence they would require. For example, many said they would like to see a comparison of firms that use market share as their objective with those that use profits. The evidence we obtained has proven to be similar to what executives sought. You might want to take a few minutes to consider what evidence you would need.

We surveyed 105 managers, one-third of whom said their companies are motivated by competitive objectives. We examined the effects of competitive objectives in businesses. And we conducted lab experiments to study managerial decision making. Such experiments permit much control but sacrifice the ability to factor in real-life situations. To balance this, we performed a field study on company performance. This accounts for the complexity of real businesses making real decisions, but lacks the controls that make the results readily interpretable.

Evidence from Managers

Imagine that you are asked to set a new product's price. You receive information about the profitability of two pricing alternatives, a low price (with low profits) and a high price (with higher profits). This is a simple decision, and most people make it as economic theory predicts. But what happens when you also are given information about your competitor's profits?

We posed this problem to people acting as marketing managers. Drawn from MBA classes and executive seminars, the majority of them had relevant managerial experience. We gave them the five-year net present worth associated with each strategy. They could choose either a low-price strategy or a higher-price strategy. The low-price strategy would allow their firm to earn twice as much as its competitor (\$40 million versus \$20 million). The higher-price strategy would allow them to double their earnings to \$80 million, but simultaneously would permit their competitor to do even better, earning \$160 million.

Sixty percent of the participants selected the low-price, strategy, sacrificing \$40 million in profits in order to best their competitor. The desire to be No. 1 outweighed economic rationality.

Perhaps they were looking beyond five years. To address this possibility, we told other participants that the results were based on 20-year net present worth. The findings were similar.

Maybe they were trying to position their firm so it would attain higher market value. To test this, we gave additional information to other participants, saying both strategies had been tried by the firm in the past. Louie, heading one division, had charged a low price and earned low profits. Harry, heading another, had charged a high price and earned higher profits. As before, Louie's profits were twice those of the competitor, and Harry's were half. We told participants each division was now for sale, and the market price was expected to be equal. When asked whom they would promote, about one-third chose Louie rather than Harry.

The results were stunning, and they have been repeated in 36 experiments with over 800 participants. It is not simply that there are many people who are so competitively-oriented they will sacrifice profits to be No. 1. Information on a competitor's performance alters many managers' decisions, thereby reducing profits. We were able to further increase the proportion of participants making less profitable decisions by exposing them to management techniques that focus on obtaining market share. For example, we gave them information about the experience curve (which encourages firms to expand output in order to lower prices). We found that using this model was detrimental to profitable decision making. We also discovered that executives who had taken strategic-management courses were more likely to make decisions that harmed profitability. In another study, we found that the Boston Consulting Group portfolio matrix methods, with their emphasis on market share, led managers to make less profitable decisions.

Evidence from Companies

Are the effects of choosing market share over profits strong enough to show up in firms' performance? The ideal way to test this would be to identify some companies that use competitor-oriented pricing objectives, and some that use profit-oriented ones. Then we would track the performance of the two groups for 20 years or so. The disadvantage of this strategy is that we wouldn't know the answer for a while.

As it turns out, we don't have to wait. A study funded by the Brookings Institution and published by Robert Lanzillotti in the *American Economic Review* in 1958 examined the pricing objectives of 20 leading corporations such as General Foods, U.S. Steel, Kroger, Sears, and Goodyear. This study provided information that allowed us to classify companies' objectives based on whether they tended to be competitor-oriented or profit-oriented. We found firms at each extreme, although most firms mixed elements of each. Firms that set competitive pricing goals had significantly lower ROI over the nine-year span from 1947 to 1955. Some executives might be concerned that market share objectives are long-term strategies, and nine years is not long enough for the benefits to appear. So we looked at another nine-year span from 1956 to 1964. The results were similar. In fact, the results remained unchanged through the end of our analysis in 1982.

In addition, we found that the companies with competitor-oriented objectives were less likely to survive. Four of the six companies that focused strictly on market share (Gulf, American Can, Swift, and National Steep did not survive. All four profit-oriented companies (DuPont, General Electric, Union Carbide, and Alcoa) did.

Advice: Focus on Profits

Based on our research, we offer CEOs some strategic guidelines to avoid falling into the competition trap:

- Do not use sports and military analogies, since they foster competitive objectives. (ignore this advice if you want to get shot down in a sudden-death overtime.)
- Design information systems to focus managers' attention on your success rather than that of your competitors.
- Ensure that benchmarking does not influence objective setting.
- Eschew management science techniques that try to maximize market share, such as the experience curve and the BCG portfolio matrix.
- Ignore training programs that rely on warfare models.
- Strive for high profitability. This is especially important when firms experience business cycles. The evidence to date shows that firms following this advice should expect a higher long-term ROI and an increased likelihood of survival.
- Avoid investing in other firms that have competitive objectives. Based on some preliminary findings, such firms have lower price-earnings ratios and smaller appreciations in market value over time than profit-oriented firms.

What does all this mean for CEOs? They should not formulate or discuss their objectives in competitive terms, such as market share. Is it possible that further studies could change our conclusions? Of course. But we wouldn't bet the company on it.

This paper is based on research studies conducted by the authors over the past eight years. For details, see "Effects of Portfolio Planning Methods on Decision Making. Empirical Results," *International Journal of Research in Marketing*, 11 (1994), pp. 73-93, and "Competitiveness and Performance: Impact of Objectives on Managerial Decision Making," Working Paper, Department of Marketing, The Wharton School, University of Pennsylvania, 1993. The research currently is supported by the Huntsman Center.